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Broker-Dealer Licensure Requirements for Officers and Directors of Issuers

The purpose of this release is to provide some clarity regarding licensure requirements for directors and officers of issuers who do not receive commissions for effecting securities transactions. A recent California Court of Appeal opinion, *People v. Cole* (2007) 156 Cal.App.4th 452, prompts the need for such clarification.

I. California Broker-Dealer Licensure Framework

A director or officer of an issuer of securities can in certain circumstances be subject to licensure as a broker-dealer or its agent. The Corporate Securities Law of 1968, as amended, (CSL) in section 25210 sets forth broker-dealer licensure requirements. Section 25210 provides, in relevant part, that no broker-dealer shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any security in California unless the broker-dealer has first applied for and secured from the Commissioner a certificate, authorizing that person to act in that capacity. Thus, the threshold licensure question is whether a person comes within the definition of broker dealer, or an exception thereto.

In relevant part, the term "broker-dealer" means any person *engaged in the business* of *effecting transactions in securities* in this state for the account of others or for his own account.

The term "engaged in the business" is not defined in the CSL. However, as discussed in Commissioner's Opinion No. 98/1C the term "engaged in the business" generally implies a "…business activity of a frequent or continuous nature," (*Advance Transformers Co. v. Superior Court* (1974) 44 Cal.App.3d 127, 134). This is in contrast to a single or occasional disconnected act. (Id.) Thus, an officer or director can fall outside the definition of the term "broker-dealer," if the person's effects securities transactions on a single or occasional basis.

Also discussed in Commissioner's Opinion No. 98/1C is the term "effecting securities transactions." Generally, negotiating a sale of securities is sufficient to satisfy this requirement. (*Zappas v. King Williams Press* (1970) 10 Cal.App.3d 768, 773).

A notable exception to the definition of broker-dealer exists for "agents" who are employees of broker-dealers and issuers. CSL subsection 25003(a) defines an agent, in relevant part, as any individual, other than a broker-dealer or a partner of a licensed broker-dealer, who represents a broker-dealer or who for compensation represents an issuer, in effecting or attempting to effect purchases or sales of securities in this state. With regard to officers and directors of an issuer, the "agent exclusion" is qualified by a requirement that directors and officers cannot receive compensation specifically related to purchases or sales of securities ("commissions").

Consistent with a plain reading of Section 25003, the Department has stated in past Commissioner's Opinions that directors and officers of issuers who are not otherwise engaged in the business of securities, and do not receive commissions for effecting securities transactions of the issuer, are not "agents."[1] Similarly, the Department has clarified that such directors and officers can also be excluded from the definition of "broker-dealer."

> [O]fficers…participating in the exchange program will not be "broker-dealers" or "agents" as those terms are defined by Sections 25004 and 25003, respectively, so long as they do not receive compensation specifically relating to the offer and sale of Kodak common stock and they are not otherwise engaged in the securities business. (Commissioner's Opinion No. 5266).

In summary, under the CSL an officer or director of an issuer can be:

- Included in the definition of broker-dealer if he or she engages in the business of effecting transactions in securities.

- Excluded from the definition of broker-dealer if he or she does not engage in the business of effecting transactions in securities.

- An agent, if he/she is included in the definition of broker-dealer, and receives commission specific to effecting transactions in securities.

- Excluded from the definition of broker-dealer if he or she engages in the business of effecting securities transactions, but does not receive commission specific to effecting transactions in securities.

Central to the determination of whether a person is subject to licensure requirements, is the receipt of commissions. As the Securities and Exchange Commission noted when

[1] Commissioner's Opinions Nos. 72/48C, 72/26C, 72/14C, 73/30C, 74/4C.

examining these licensure issues, "[c]ompensation based on transactions in securities can induce high pressure sales tactics and other problems of investor protection which require application of broker-dealer regulation…."[2] Accordingly, based on Section 25003, the receipt of commissions is controlling in determining licensure requirements.

II. California Case Law Interpretations

A recent California criminal case, *People v. Cole* (2007) 156 Cal.App.4th 452, examined broker-dealer licensure requirements for directors and officers of an issuer. The *Cole* defendants formed a corporation that sold its own promissory notes. Among the many securities law violations committed by the defendants, were violations of broker-dealer licensure requirements under the Corporate Securities Law of 1968. As noted throughout the *Cole* opinion, the transactions appear to have been systematically structured to perpetrate fraud upon California investors, many of whom were elderly investors with very limited financial resources.

The defendants in Cole were convicted of selling securities without a broker-dealer license. In this regard, the *Cole* defendants conceded that they fell within the general definition of the term broker-dealer, but argued that they were within the "agent" exclusion to the definition of broker-dealer.[3]

The court held that since the defendants did not receive commissions for the sale of securities, they were not "agents" of the issuer. Accordingly, the court never examined the entire licensure framework and instead analyzed the broker-dealer definition only as necessary, to interpret the "agent" exclusion. Thus, the court's holding appears to relate solely to whether the defendants were "agents." The court's holding in this regard is consistent with a plain reading of the statute and Commissioner's Opinions.

The seeming anomaly concerning whether the defendants are broker-dealers stems from their concessions in this regard. Since the defendants conceded that they fell within the definition of broker-dealer, it was unnecessary for the court to analyze the licensing requirements. Accordingly, a strategic litigation decision by defendants created an apparent conflict with the Department's past interpretation.

III. SEC Policy

The Department's past interpretive opinions are generally consistent with federal broker-dealer regulations adopted by the Securities and Exchange Commission.[4] The applicable SEC rule provides guidance in situations where an issuer chooses to sell its securities through its directors and officers.[5] The rule generally exempts officers and directors who meet specified conditions from broker-dealer registration requirements

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[2] Securities Exchange Act Release No. 22172 (July 9, 1985), 50 FR 27940, (July 9, 1985).
[3] *People v. Cole* (2007) 156 Cal.App.4th 452, 479.
[4] Rule 3a4-1 (17 CFR 240.3a4-1).
[5] Securities Exchange Act Release No. 22172 (July 9, 1985), 50 FR 27940, (July 9, 1985).

under Section 15 of the Securities and Exchange Act of 1934.[6] The SEC adopted the rule in light of the fact "that there are situations where imposition of [broker] registration requirement would be inappropriate."[7]

The rule is drafted as a safe harbor, and applies to "associated persons" of an issuer. The term "associated person" generally includes officers, directors, partners or employees of an issuer of securities. An "associated person" must also satisfy a number of secondary requirements in order to meet the safe harbor requirements. For example, the "associated person" may not be subject to certain statutory disqualifications, and may not be compensated in connection with the sale of the issuer's securities by the payment of commissions.

IV. Conclusion

The Department's position is that the decision of *Cole* has limited impact and should not be read to stand for the proposition that officers and directors of issuers must be licensed as broker-dealers or broker-dealer agents unless they receive a commission for the sale of securities.

While broker-dealer licensure requirements are essential to investor and industry protection, an overly broad reading of *Cole* would frustrate the Department's ability to implement and enforce licensure requirements effectively, and would create tremendous burdens for businesses without providing corresponding investor protection.

The Commissioner does not believe *Cole*, in most respects, represents a departure from existing licensure requirements. Nonetheless, the Commissioner believes this Release is necessary at this time, until the Department considers whether the adoption of more formal regulations, such as those that mirror the federal "safe harbor" regulations, in order to provide better guidance and clarity to businesses seeking to raise capital in California.

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[6] Id.
[7] Id.